March 2013

Your Future is Worth a Second Look

By Kevin Q. Williams,
Owner, Williams Financial
Services Corporation

Before you file or shred your year-end investment statements, take another look. While last year's stock market results gave many the feeling of euphoria, you may want to look closely at the level of risk you're taking in 2013. Investors understand that risk and return are related, but the average investor is typically only focused on one or the other. When the market is doing well, we are focused on returns. When the market is doing poorly, we are focused on risk. The average investor would do better if he/she focused on risk when the market is doing well and vice versa.

As humans, we are wired to extrapolate the current trends into the future. According to various Dalbar studies, when current trend riding is combined with the emotions of investing, the average investor usually only captures a small portion of the long-term returns of the markets.

A recent study of large defined contribution plans[i] indicated that near-retirees do not seek help with their retirement plans as frequently as other age groups. Many near-retirees who did not obtain professional guidance took on considerable risk, expecting a certain return. Due to inefficient portfolios, these near-retirees experienced sub-optimal returns given the risk they took.

Regardless of your age group, there are three actions you should consider now for your portfolio before the tide goes out and reveals your exposure:

1. Assess the risk adjusted returns of your portfolio. A wealth manager or investment counselor can help you calculate the various ratios, including Sharpe ratio, Alpha, Beta and standard deviation. Since a picture is worth a thousand words, plot the risk and return of your portfolio against the efficient portfolio. The graph will depict whether you are taking too much risk for the return you have received.

2. Consider the need to rebalance your portfolio if you utilize asset class investing. Asset class investing requires grouping securities that have similar characteristics into asset classes and selecting those that have the least amount of correlation with each other or those that will behave differently to various market conditions. Ideally, you want asset classes that will be up when other asset classes are down in value.

Rebalancing the portfolio is a method of periodically buying low and selling high, whereby you sell the assets that have performed well relative to other asset classes and buy the asset classes that have not performed well relative to other asset classes. While asset classes investing and rebalancing are methods that reduce risk, neither method guarantees against losses.

3. If you are a long term investor, use an appropriate long term strategy. If you have made significant portfolio decisions based on the elections, the Fiscal Cliff or the European crisis, this might cost you in the long run, as you could be forever chasing the wind as a market timer. A long term investor should not get caught up in the short term issues of the market. For example, in the 1980s, the savings and loan industry was exposed for having a disconnected strategy between short term liabilities and long-term assets.

Although both risk and return are seldom felt in a given year, the prudent investor always considers risk-adjusted returns. A wealth manager can help you make sure you are getting compensated for the appropriate risk level and that you are adhering to prudent long-term strategy. Before the market changes, make sure your portfolio reflects that of a long-term investor rather than a gambler.

---

[i] Help in Defined Contribution Plans: 2006 Through 2010 by Financial Engines and Hewitt Aon. September 2011

Kevin Q. Williams, MBA, CPA/PFS, CFP® is a financial coach to successful business owners and families in the Baltimore-Washington, D.C. area. For over 20 years, Kevin has been helping clients make smart financial decisions, so that they can leave a legacy to future generations.